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Dual Currency System as a Solution to the Eurozone Crisis

Summary: The paper discusses the role of a dual currency system as a solution to problems experienced by some eurozone countries, especially Greece. The dual currency system as suggested by the author would consist of the euro and a reintroduced national currency, referred to as the "new drachma".

The concept originates from an analysis of the roots of the present crisis, which include a severe loss of international competitiveness by countries hardest hit by the crisis. The analysis leads to the conclusion that devaluation (as opposed to "internal devaluation") may be crucial to dealing with the problems at hand.

Devaluation is impossible without a national currency and – as far as the literature claims – without a redenomination of assets and liabilities, the author says. However, reintroducing a national currency combined with redenomination would produce many legal, political and economic problems, Koronowski says. He investigates these problems and concludes that an exit from the Economic and Monetary Union (EMU) would have disastrous consequences for the European Union.

Meanwhile, a model based on reintroducing a national currency without leaving the EMU would make it possible to minimize, if not completely avoid, these problems, the author says. The article offers an outline of such a model.

Keywords: euro area, monetary integration, dual currency system

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Introduction

This paper aims to discuss the role of a dual currency system as a solution to problems experienced by some eurozone countries, in particular Greece.

The concept of a dual currency system is far from previous ideas on how to deal with the situation in the eurozone – most of these ideas could well turn out to be insufficient to remedy the problem. The dual currency system as suggested in this paper would consist of the euro and a reintroduced national currency, referred to as the "new drachma".

The concept originates from an analysis of the roots of the present crisis, which include a severe loss of international competitiveness by countries hardest hit by the crisis and a strong balance-of-payments aspect. The analysis leads to the conclusion that devaluation (as opposed to "internal devaluation") may be crucial to solving the problems involved.

Since devaluation is impossible without a national currency, its reintroduction is an option considered in some scenarios of future developments in the European monetary union. These scenarios include projects short-listed for the Wolfson economics prize in 2012. However, reintroducing a national currency to replace the euro would bring about many legal, political and economic problems related to the redenomination of assets and liabilities. This usually prompts suggestions that such moves should be made in secrecy. The problem is that a redenomination process carried out in secrecy would be against the law and deeply unfair; nor would it resolve many of the legal and economic problems involved, and it would thus be far from an "orderly" exit. Such an operation, though problematic, could only help avoid panic and excessive capital outflows ahead of the change.

Reintroducing a national currency without having the country leave the monetary union would help avoid opening a Pandora's box of redenomination, while preserving the basic institutional and legal structure of the eurozone and at the same time grasping the advantages of devaluation. A dual-currency system might be a long-lasting facility, but it could also be a temporary step towards either a complete and orderly exit from the monetary union or a return to the single, common currency.

Although Greece and the drachma are used as an example due to the particularly severe problems of this country, the idea presented in this paper may have broader applications. The idea assumes – and requires – continued existence of the euro, but it permits a reintroduction of the domestic currency by a few countries. Eventually, under the solution presented in this paper, the euro could become an international currency, while each member of the Economic and Monetary Union (EMU) could introduce a parallel domestic currency.

The content and conclusions of this paper may seem to be technical in nature and relate to a situation that is only hypothetical. In fact, solving the problem in question is of great importance to the present political process and economic policy in the European Union. If an exit from the monetary union or a complete breakup of the EMU would be very costly and impossible to be

organized in an orderly manner, the eurozone should be saved "at any price", according to Mario Draghi, president of the European Central Bank (ECB). This price includes continued bailout programs and ECB interventions on sovereign debt markets. The claims that dismantling the monetary union would be a catastrophe are also the main argument for a persistent "deepening" of European integration, including new fiscal rules and the banking union, which is often perceived as a gradual process of creating a federal European state. If, however, it is not true that a breakup of the eurozone would spell disaster, then perhaps there are other, better solutions than deeper integration.

Why reintroducing a national currency could help

In this part of the paper, the origins and character of the present crisis in the EMU are briefly analyzed. The analysis justifies an opinion that reintroducing national currencies in some eurozone countries may be advisable or even unavoidable.

Before the present crisis erupted and before the public finances of some EMU member countries went out of control there were tensions within the euro area. In 2008, new problems emerged and captured public interest, but the old tensions did not disappear; just the opposite, they seem to be closely interlinked with the present fiscal and banking crisis in some eurozone countries.

The mechanism of these tensions was triggered in some EMU countries by the reaction of economic agents and particularly consumers to a decline in interest rates after these countries entered the euro area. As a result, the economy became overheated and inflation was slightly but persistently higher in these countries than the eurozone average [early analysis: European Commission 2001]. Eventually, it brought about a considerable "real exchange rate appreciation" and a loss of international competitiveness [European Commission 2005; Wyplosz 2006a, 2006b]. Current-account deficits emerged/increased. As liabilities grew, possibilities to further accumulate the debt and run up current-account deficits approached a limit[1]. This eventually called for a reduction in private and/or public spending. These imbalances within the monetary union could not be eliminated and contractionary developments could not be offset by a depreciation of a national currency and growing exports. As a consequence, the economy stagnated and excessive public deficits emerged [Koronowski 2009].

The above scenario is best illustrated by the PIIGS countries – Portugal, Italy, Ireland, Greece, and Spain – which have experienced the most severe problems during the present crisis. The competitiveness of the Italian economy versus other eurozone economies (measured by changes in export prices)

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1 Some countries experiencing payment imbalances, in particular Greece, have only slightly reduced their current-account deficits. They have benefited from various relief programs and changes in the monetary policy of the ECB, which softened the international budget constraint [Gros 2012].

declined by 27% from 1999 to 2006; Spain saw a 12% drop, and Greece slid by 10% [Wyplosz 2006b]. Portugal and Ireland follow the general pattern although some additional factors played a role there [Koronowski 2009]. The same pattern of cyclical developments has been observed and described in the literature on fixed exchange rate nominal anchors in stabilization programs; in that case the boom and bust cycles used to end with a currency crisis[2].

The case of Portugal constitutes a clear example of this kind of developments, which started there even before 1999 when the country was in the ERM2 exchange rate system and struggling to meet the Maastricht criteria. Inflation decreased from above 10% at the beginning of the 1990s to less than 2% in 1997. When Portugal became a member of the eurozone inflation increased slightly; in 2001 it was 4.4%. With low nominal interest rates, the real interest rate fell from 6% in 1992 to 0% in 2001. As a result, high demand and an economic boom followed; the unemployment rate fell from 7.3% in 1995 to 3.9% in 2000. The economy was growing fast; in 1998 the rate of growth was close to 5%. Public proceeds from taxes were high and the public deficit was reduced from 5.5% of GDP in 1995 to 2.7% in 1999, although the government did not undertake any structural reforms [Basto 2007].

This was only a nice prelude to serious problems. The economic boom caused wage increases out of step with productivity growth. In Portugal, unit labor costs (ULC) increased by 22% between 1998 and 2005, while the average ULC growth in the eurozone was 2% in the same period. Despite rising costs, Portuguese export prices remained relatively stable, yet profit margins in export-oriented sectors fell. As a consequence, exports were weak, and Portugal was losing its share in world trade. These developments were extensively presented in an IMF country report [IMF 2006]. The report concluded that Portugal needed a few years of fast productivity growth to compensate for lost competitiveness. Such a scenario was rather improbable and the financial crisis of 2008 eventually left no time for adjustment.

Weakening competitiveness made the current-account deficit rise from 3.5% of GDP in 1995 to 10% in 2000. The spending boom brought about a fast increase in private-sector debt. The rise was limited, however, by the level of bank loans incurred by households and by accumulated foreign liabilities, which testified to an excessive use of external financing. Spending had to be cut and the economy started slowing down; in 2003 it was in recession [Basto 2007; Blanchard 2006]. Unemployment began growing in 2001 and by 2005 it had again overshot 7%. The public deficit started increasing in 2000; in 2001 it exceeded the Stability and Growth Pact limit of 3% and in 2005 it was above 6% of GDP [Basto 2007]. Thanks to cuts in public spending, it was reduced below 4% a year later, but real difficulties were still ahead. In spite of a recession, inflation remained relatively high and did not fall below the eurozone

[2] For more about these cycles see Kiguel and Liviatan [1992], Calvo and Vegh [1992], Santaella and Vela [1996], Khamis [1996].

average until 2008. Excessive current-account deficits continued and increased further during the crisis.

The role of balance-of-payments imbalances in the eurozone crisis has been recognized (though rather weakly) by the European Commission [2009, p. 193]: "The loss of the exchange rate as an adjustment instrument may imply protracted periods of self-reinforcing destabilising dynamics due to price and wage rigidities. Current account imbalances and net foreign asset positions can in turn play an important role in a context of exacerbated tensions in financial markets".

Visser [1995, p. 136] discussed the same problem much earlier in the context of the theory of optimum currency areas. In his critique of Ingram's view that a high degree of financial integration should be an argument in favor of a currency area (a criterion of the optimum currency area), Visser wrote: "If, for instance, diverging cost developments cause chronic sizeable current-account imbalances, wealth holders may at some point refuse to accumulate the debt of the deficit country. Capital inflows dry up and speculative attacks against the currency of the deficit country are to be expected, forcing a devaluation". Visser formulated his reservations in the traditional optimum currency area terms of fixed exchange rates and possible devaluations. In a monetary union there could not be a speculative attack against a currency or devaluation but wealth holders may still refuse to further accumulate the debt of the deficit country, in particular its government or financial institutions. In this juncture, there is no exchange rate risk that could spur investors to sell the currency of the deficit country but credit risk matters and is even exacerbated by the absence of the exchange rate adjustment mechanism; it would be very difficult to service (foreign) debt as long as there is no improvement in the current account, no reasonable economic growth and no sufficient domestic savings. The problem of excessive debt may pertain to both public and private agents. However, government bond markets would be usually most liquid and react most abruptly. Moreover, current-account deficits and a stagnating economy have a strong negative impact on public finances and crucially diminish any room for fiscal maneuver. Imposing higher taxes on private agents who barely service their own debts and who still borrow even more in spite of tough market conditions would be rather difficult and dangerous. Any attempt to cut public spending would badly influence incomes and worsen the situation of both private borrowers and financial institutions.

Excessive private-sector debt, in particular that related to a real estate bubble, badly influences the situation of the financial sector, and avoiding an open banking crisis puts a further strain on public finances.

Balance-of-payments imbalances may be a crucial factor in the present eurozone crisis although fiscal disequilibria and weak banking systems draw the most attention. Closer analysis shows that countries which experienced most market pressure and which were subject to major rating downgrades were not only in a poor fiscal situation, but also had high or extreme and

persistent current-account deficits and highly negative net international investment positions [Koronowski 2011]. This is the case with Greece, Spain, Portugal and, to a lesser extent, Italy. Among the PIIGS countries, the only exception is Ireland, which had its government bond spreads roaring in spite of a relatively good external position. In this case, other factors, particularly exorbitant banking sector losses and related fiscal expenditures, seem to have played a major role.

A good example of the role of the balance of payments versus the fiscal stance is the United Kingdom where the public deficit was in the double digits and the fiscal situation in general (comprising both the deficits and debt) was worse than in Spain. Despite that the country did not experience major market pressure; the UK preserved a strong external position accommodated with a deep depreciation of the British pound. Belgium did not experience much market pressure either, despite its public debt comparable to that in Greece or Italy and a relatively high public deficit; again the country had no balance-of-payments deficit or highly negative international investment position. By contrast, Spain had a lower public debt than "benchmark" Germany and also lower than the average for the European Union and the eurozone. This did not help the country avoid a strong crisis – Spain faces considerable balance-of-payments imbalances, in addition to a real estate bubble. Italy has been "saved" although it reached a very high public debt level; the country continued to record moderate current-account deficits, accompanied by a relatively good net international investment position and a moderate public deficit.

These examples are far from a broad and comprehensive presentation of the role of balance-of-payments versus fiscal imbalances[3]. However, they clearly show that current accounts have a major impact on the severity of the crisis and market sentiment. Another conclusion is that, although the "twin deficit" mechanism sometimes plays an important role, developments in the private sector are a major factor as well. A current-account deficit and foreign debt may result from high household spending and borrowing during the boom phase. Fiscal deterioration may be due to a contraction during the crisis and the bust phase of the cycle as described above. Moreover, markets seem to be much more indulgent with respect to fiscal imbalances if only countries preserve a fair external position.

These days it seems evident that the eurozone is experiencing major problems due to the loss of competitiveness by some member countries. This can be reversed by either an "internal devaluation" or a full-on devaluation; however, the latter is impossible unless there is a national currency.

In theory, an "internal devaluation" is possible, but in social and political practice, it is rather difficult, costly and improbable. Estonia is an example of

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[3] For a detailed discussion of this problem, see [Koronowski 2011] – the paper offers comparative current-account, public deficit and debt statistics, as well as a wealth of data on the international investment position, private-sector spending and debt of a selected group of EU member countries.

a country where such a devaluation worked or at least where huge payments imbalances were eliminated [Koronowski 2012]. The country managed to turn its current-account deficit of above 17% of GDP in 2007 into a surplus of 4.5% of GDP two years later. However, GDP contracted by 5.1% in 2008 and then again by 16.1% in 2009. The unemployment rate reached almost 17% in 2010. It is also important that labor productivity decreased in 2008 and 2009; it may sound nice that productivity should grow fast where competitiveness has been lost and the current-account deficit is excessive, but that does not happen very often, not even in countries undertaking major balance-of-payments alignments. Neither the acceptance of such a cost of economic contraction nor a fast rise in productivity seem to be a viable option for countries such as Greece.

In effect, the reintroduction of a national currency at a devalued exchange rate may turn out to be a solution to the present conundrum. Eurozone exit contingency plans have been drafted. In particular, several scenarios for a breakup of the EMU have been submitted for the Wolfson Economics Prize in 2012. In the next part of the paper I will refer to these scenarios and discuss why leaving the eurozone is so difficult.

Why an orderly, low-cost exit from the EMU is impossible

In this paper I consider only a situation when a single country reintroduces its currency, while the eurozone, the monetary union and the euro continue to exist. This approach could be applied to more than one country as long as it does not mean a complete breakup that would make the euro cease to exist or split into the "southern" and "northern" euros. Even so leaving the eurozone would be a complicated process legally, politically, economically and technically.

An important legal aspect is the lack of any provisions that would regulate or explicitly allow an exit from the monetary union. Leaving the eurozone would violate the European Treaties and be tantamount to leaving the European Union. However, a mild interpretation of the European Treaties suggests that "the view that there are no circumstances under which a government can exit the euro-zone without also leaving the EU is probably not as robust as widely assumed" [Bootle 2012]. There is no formal mechanism for expelling a country from the EU (in contrast to the procedure for voluntary withdrawal under Article 50). Nevertheless, other EU members could simply refuse to cooperate with a country that leaves the eurozone, impose fines and suspend its membership rights. A unilateral decision to leave the monetary union would make little sense and create political tensions. At the same time, it would be very difficult to reach an international consent, given the problems discussed below.

Major legal problems could result from a redenomination of assets and liabilities. There is a reasonable expectation that obligations governed by the law of the exiting country could be redenominated according to the well established

rule of *lex monetae* and any financial instruments governed by foreign law could not be legally redenominated; such an attempt would only lead to court disputes and add uncertainty to the process [Nordvig and Firoozye 2012].

Redenomination, even if planned in secrecy and introduced unexpectedly, which seems rather difficult, might necessitate introducing capital controls to avoid disruptive flows anticipating the change. However, "one immediate stumbling block is that any country that seeks to impose capital controls would be in clear breach of its existing treaty obligations. After all, the free flow of people, goods and capital is fundamental to the EU. These capital controls could therefore be overturned in the European courts and even in the national courts of the exiting country. [...] There is a provision [Article 59] which might allow the temporary imposition of capital controls for a period not exceeding six months, if approved by the Commission and the ECB and agreed by a qualified majority of states. [...] However, it may be impossible to build the required amount of support in advance without forewarning everyone that capital controls are coming" [Bootle 2012]. The case of Cyprus casts doubts on whether these provisions are really binding; whatever the case, the problem exists.

All the above legal problems cause major political challenges, both domestic and international. Redenomination would bring about a huge redistribution of wealth and one should not expect that losers would not protest fiercely. With respect to foreign affairs, to leave the eurozone and stay in the EU would necessitate full cooperation of other EU member states and a commonly shared "innovative" interpretation of the Treaties. Support from European institutions, including the ECB, might be crucial for minimizing unnecessary disruption. Capital controls, as noted above, might be introduced only with the general consent of EU member states – or at least they should be accepted after having been imposed.

It is difficult to imagine how necessary domestic and international preparations for a devaluation and leaving the eurozone could be made in secrecy. Moreover, secrecy is a political problem in itself. It has an ominous meaning for democratic processes and control, credibility of national authorities and public support for measures undertaken. It is impossible to imagine that wide political inter-party consultations or parliamentary debate on whether and how to leave the eurozone could be kept secret. The decision to denominate would have an immense effect in terms of wealth redistribution. A secret and authoritarian way in which the authorities would impose huge losses on large groups of citizens would demolish the public credibility of the authorities – a process crucial for the next steps in the process of balancing and stabilizing the economy. Political destabilization would almost inevitably follow. It is very bitter that European integration has led to complex problems that sometimes elicit non-democratic solutions. Such solutions must not be accepted. However, the initial plan to "tax" all deposits in Cypriot banks is proof that European leaders do not hesitate much when it comes to saving the euro at

the expense of legal and democratic rules or vested interests of the citizens. That they are not allowed to do so freely is a good sign.

In spite of that, the secrecy of leaving the eurozone is a crucial feature of the process as envisaged in all the papers short-listed for the Wolfson Economics Prize. It is even more embarrassing when one considers that all these papers admit that secrecy would be impossible to sustain.

A redenomination of financial instruments would have an immense economic impact on the government, financial institutions, enterprises and households in the exiting country and abroad.

In the case of the government, the most important effect would be a decline in the value of the public debt expressed in the euro. Most of it is governed by the domestic law [for Greece cf. Nordvig and Firoozye 2012] and it could be redenominated and subsequently depreciated, possibly also due to inflation. How the public debt would change in terms of GDP, except for inflationary depreciation of its real value, is a more complicated issue; many components of GDP would change with redenomination. Also government revenue would be in drachmas. Interest rates would probably go much higher and the refinancing terms would worsen. A positive effect for the fiscal position should rather come from medium- and long-term economic growth regained due to the reintroduction of the national currency.

Redenomination of the public debt would have a strong impact on financial institutions in the exiting country and abroad. This would cause huge losses and a currency mismatch in the balances of financial institutions. However, redenomination of deposits would alleviate the pressures domestically. The very existence of many banks and avoiding a systemic collapse would probably necessitate immense capital injections from the government and enormous liquidity support from the central bank. Of course, the room for maneuver by the government would be limited at best. No doubt, foreign support for an action that would severely hit financial institutions abroad in an ultimately uncontrolled manner should not be expected.

In the case of industrial enterprises, the impact of redenomination of financial instruments would certainly be differentiated. It would depend on the level of debt incurred and its legal governance. Of course, the share of domestic and foreign proceeds would matter for the current financial situation of individual enterprises; generally speaking, exporters should find their situation improved.

When it comes to households, they would rather lose out on redenomination; they are net wealth holders of assets governed by domestic law [Bootle 2012]. This could not only spur political discontent but also depress spending and hinder economic recovery.

The scale of redenomination and depreciation of financial instruments, their impact on different types of agents and their mutual influence (including the impact on enterprises' failure to service their debts to banks and on the needed bank bailout by the government) are difficult to assess precisely.

Some general remarks can be found in the literature [for example, in Bootle 2012, and in Nordvig and Firoozye 2012], but much is left vague. This adds to the uncertainties and risks associated with leaving the eurozone. Probably there are some secret contingency projections prepared by central banks or governments and also by major financial institutions with respect to their own position.

An important aspect of a breakup of the eurozone or an exit of some members – scenarios that have generated heated debate recently – is the issue of the so-called Target2 balances [e.g. Sinn 2011, 2012; De Grauve and Ji 2012]. The way the ECB functions as a central bank with a federal structure is responsible for the high liabilities that some national central banks, in particular the Greek central bank, accumulated versus other national central banks, mainly the Bundesbank. As long as the eurozone operates this debt does not bring about any major consequences, except that it is a manifestation of a lack of a hard budget constraint in the deficit countries [Gros 2012]. However, if a debtor country leaves the eurozone and the national central bank ceases to be a part of the Eurosystem, the legal status of this debt becomes doubtful. Even if the country takes liability for its central bank's debt it is "backed" by the assets of the bank amassed via open market operations. First, these assets are mostly governed by the local law and would be denominated and, second, they are of a very low quality (as accepted by relaxed ECB rules), especially in the context of a possible exit. There is little doubt that the central banks of surplus countries would incur huge losses. Although they are well prepared to bear such losses, the result would be a de facto transfer of citizens' wealth from surplus countries in favor of deficit countries – a process that would inevitably cause major international political disputes, making the process of exiting the eurozone far from orderly in this respect [Sinn 2012].

The last dimension of reintroducing a national currency is technical: printing and minting new banknotes and coins. The main problem related to this is secrecy. The euro cash in circulation could not be simply redenominated; it could not be stamped (no one would stamp euro notes because this would not change their status or value). Actually, it is impossible to introduce new coins and banknotes or keep the old ones representing the new currency (stamped euros) unexpectedly, orderly and quickly enough. This gives rise to some proposals for specific solutions, for example a period of non-cash payments in the new currency and cash payments in the euro [Bootle 2012]. That would be rather difficult to do, having in mind the exchange rate changing freely and possibly fast. It is difficult to imagine people having their wages paid in drachmas but withdrawing euros from their accounts. Most probably an immediate result would be a bank run. Also non-cash transactions denominated in the new currency could be quite problematic. Without a doubt they would need a period of intensive preparations, including changes in software systems.

According to Dobbs [2012], "a bigger challenge would be that multinational corporations and financial institutions would need time to adjust their systems

and accounts for the new currency. As a reference, two years were allowed between the euro exchange rates being locked and the launch of the euro as legal tender, including the use of physical notes and coins. [...] (A)n overnight redenomination is therefore not possible and there would need to be some hiatus period of a minimum of three months up to the formal launch of the new currencies. During that period, consumers, corporations and speculators are likely to try to move their cash and savings that will be redenominated in the new [...] currency to financial institutions where they will remain in euros. They would have an incentive to withdraw and hoard old euro notes in cash. And if capital controls were imposed, as would seem necessary, euro notes could still be smuggled over the border, though the governments could try to force the notes to be redenominated [stamped – A.K.]. These capital controls are illegal under EU law, resulting in potentially years of litigation".

This part of the paper is not intended to extensively discuss all the problems and risks involved or to assess the full costs of leaving the monetary union. My aim here is only to note that legal, political, economic and technical problems related to exiting the eurozone are enormous and interconnected. The solution I present in the next part of the paper, though not completely risk and cost free, makes it possible to avoid these problems.

How to reintroduce a national currency and stay in the EMU

In the first part of the paper, I argued that reintroducing a national currency at a devalued exchange rate is a way (probably with no good alternatives) to regain the balance and growth in eurozone economies hardest hit by the crisis. In the second part, I briefly discussed the severe problems and immense costs related to leaving the monetary union. It may thus seem that neither to stay nor to leave is a good option. However, below I am going to suggest a solution to this dilemma and show how a country can reintroduce its national currency and stay in the EMU.

Various researchers have addressed this problem, looking for a "third way". For example, according to Le Grand [2012], "One way of overcoming at least some of these problems would be the following. At a given moment in time, a deficit country withdraws from the euro[zone] and denominates all its financial transactions in a temporary currency at a given exchange rate. It then immediately rejoins the euro[zone] but at a weaker exchange rate. Denote this QIR, for quit and instantly rejoin [...] This form of QIR would be a devaluation with the same beneficial consequences for improving a country's competitiveness, but without all the practical problems associated with introducing a new currency".

In assessing the above proposal, I fully agree with Bootle [2012], who argues that "an additional question regarding the form of a break-up is whether it is possible for a country to leave the euro-zone on a temporary basis, in order to improve its competiveness, before then returning to the currency union. [...]

Suffice it to say here that we do not view that as a realistic option nor is the idea of an overnight technical deflation which did not need painful adjustment over a long period. The notion of some clever, technical trick that offers an escape from the nasty choice of external devaluation or internal deflation is a chimera".

In fact, it is difficult to imagine an effective and sustainable redenomination/deflation declared overnight without firmly introducing a new currency. With respect to financial instruments, including deposits and all forms of debt governed by domestic law, it would be identical with a generally declared default on all obligations, on the one hand, and a form of a partial expropriation with regard to financial assets, on the other. It would create economic costs and risks as well as political tensions related to redenomination into a new currency, and it would be very doubtful in legal terms and would certainly lead to lots of litigation and legal chaos. It is highly improbable that this kind of redenomination could bring about a sustainable decrease in the level of wages and prices set on a free market without any actual change of currency. In this sense, QIR would eventually be completely ineffective as an instrument to improve competitiveness. As QIR assumes leaving the eurozone (though only temporarily, for a very short period of time), it does not resolve the problems of a breach of Treaty obligations and resulting political disputes. QIR would merely make it possible to avoid the costs of printing new cash, but this is certainly not enough to justify this unfortunate proposal.

I argue here for an option based on reintroducing a national currency without leaving the eurozone. Such a move would not involve any redenomination of existing euro-denominated financial instruments, liabilities or assets. Just the opposite, it should be clearly declared in advance that the new currency would only be used for new transactions and financial instruments. Since the reintroduction of a national currency would not alter any earlier contracts, there would be no reason for a bank run, capital outflow or secrecy to avoid associated problems. There would be no political tension resulting from financial losses due to redenomination, on the one hand, and secrecy, on the other. Cash could be openly prepared in advance, which should help manage the process in an orderly manner. Prices should be obligatorily quoted in the new drachma, which would be declared legal tender. The drachma would be freely convertible into the euro, but in practice the new currency would only be used domestically.

The exchange rate would be set on the market for the currency; however, a controlled exchange rate rather than a free float would be the best choice. Preparations to establish the necessary market infrastructure could be made in advance of "D-Day" – the day when the new currency would be introduced. There would be no one-step devaluation but a process of market depreciation. The starting rate would be 1:1 for simplicity, transparency and avoiding any sense of administratively forced change of economic conditions.

The introduction of the new currency would not compromise any existing domestic or international legal and financial obligations. In particular, the country would fully respect all its obligations (and rights) as a member of the EMU (including Target2 balances). The new money would supplement the common currency and replace it only where it should become legal tender domestically. This might be viewed as a legal trick against the spirit of the Treaties, but it should not be considered a breach of European law, at least not to the same extent as an exit from the monetary union. It should help reach international political consensus and ensure cooperation. Moreover, any capital controls would be unnecessary and the country could respect all its obligations as a member of the European Union and its single market. What is crucial here is that the national central bank would remain a part of the Eurosystem. It would, however, freely exchange euros for drachmas and vice versa. These exchange transactions would be the only source of the new domestic currency (possible exceptions are discussed below). The country would stay in the monetary union and additionally use a domestic currency; it would thus operate under a dual currency system. The central bank would not set interest rates in the drachma; the rates would be fully determined by the market.

However, reintroducing the national currency creates some risks and costs, even if this done within the dual currency system.

The aim behind reintroducing the national currency is to improve competitiveness. Hence the drachma must depreciate and thus make wage costs and prices of domestic products expressed in the euro fall. Some depreciation would be desirable, but there could be too much of a good thing. A positive aspect of the problem is that there would be no drachmas or drachma-denominated assets that could become subject to massive sales. In fact, on the first day, there would be no drachmas at all and all agents obliged to use them to pay wages or taxes or perform any transactions where the drachma would be the only legal tender, would have to exchange euros in their possession for the new currency. Of course, the central bank could sell drachmas without limits, initially at the 1:1 rate. If the exchange rate depreciated on the foreign exchange market too much at a given moment, the bank could relatively easily intervene (buy) on the shallow drachma market; in principle it could easily buy back the entire issue, which should make the value of the drachma soar. At an early stage of the dual currency system, the central bank would in fact have full control over the exchange rate. It could use it to dose the depreciation at an optimum rate.

An important aspect of this process is credibility. It should be clear that the new currency would not be junk money. The exchange rate should not fall quickly or it should even stay perfectly stable for a period of time. However, it should be also clear that the new currency would depreciate against the euro; the external devaluation is the mechanism to gain so much needed improvement in competitiveness.

Another aspect of credibility is price stability. Any increase in drachma prices and wages would dent the improvement in competitiveness due to depreciation. Moreover, in a situation where all obligations existing on D-Day would remain denominated in euros (or foreign currencies); inflation would not make their real value fall. There would be no "debt depreciation", in particular with regard to the public debt due. Hence it is clear that inflation would have no positive effects, which would not be so certain in the case of a redenomination covering excessive public financial obligations. This unequivocal attitude toward inflation could support credibility in terms of both the exchange rate and price stability.

However, there remains the tricky issue of managing the process of an optimum external depreciation and keeping inflation as low as possible at the same time. It is real depreciation that should improve competitiveness and thus make export incomes grow, boost the economy and eventually bring higher tax revenue for the government. The issuing of drachmas would be based on selling the new currency for euros. As I argued above, the central bank would have much discretion with respect to the exchange rate. At the beginning, the rate could be stable but soon it should start depreciating slowly. The drachma issue system would be similar to an "informal crawling currency board system" with the monetary policy of the Greek National Bank still run within the Eurosystem. There would certainly be no excessive capital inflow into drachma-denominated assets, which could make the new money supply get out of control and cause inflationary pressures, as in the case of Estonia's currency board, for example [Koronowski 2012]. Drachmas would be needed only to the extent they should serve transactions as legal tender.

The role of the drachma versus the euro is very important. Leaving too much room for quoting prices and performing transactions in the euro would lead to a situation in which the introduction of the new currency would have little effect on the economy; economic agents would continue to use the euro as the main unit of accounting. The result would be a general indexing of all prices quoted in the drachma commensurate with the extent of exchange rate depreciation; inflation in terms of drachma prices would wipe off any positive impact depreciation could have on competitiveness. This is why the drachma should be declared the only legal tender in most transactions in retail, all transactions in wholesale trade, and in the case of public obligations (taxes), wages and remuneration. It should be also clear that all prices would be redenominated by law into the drachma at the official rate, 1:1 on D-Day. An information campaign should be an important part of reintroducing the national currency to forge desirable expectations and attitudes.

The fact that the denomination would not apply to liabilities and assets existing on D-Day does not mean that the introduction of the new currency would not have an important impact on the financial situation of many economic agents. In particular, many of them, including the government, would keep their euro-denominated assets but would be getting most of their future

incomes in drachmas. The drachma could be freely exchanged for the euro but at a depreciated rate. This could make debt servicing difficult for many firms, households and, last but not least, the government. The result could be growing problems in the financial sector. However, there would be no losses or negative implications due to a balance sheet currency mismatch triggered by the redenomination of assets and liabilities and devaluation; and such losses could be particularly devastating for the financial sector and many firms. Moreover, if the problems become too severe the central bank could use its power to control – slow down or reverse – the rate of depreciation.

Any proposals for an exit from the monetary union assume a redenomination of financial instruments governed by domestic law. This, together with a devaluation of the new currency, is a form of default. In comparison with this situation, a lack of redenomination of financial instruments as proposed in this paper is a major difference – though I do not mean to argue that a default on public debt would not be a necessary element of rebalancing the economy. However, such a default can always be arranged – and agreed on – on a "regular basis" instead of being unilaterally declared with respect to all classes of financial instruments governed by domestic law. The latter solution imposes huge and uncontrollable losses on many agents, especially financial institutions abroad. This may be a source of major problems, while the idea presented in this paper leaves room for a default in the form of an orderly, negotiated debt restructuring operation, potentially selective and restricted to government debt. This should have a much less adverse effect on creditors as well as the credibility of the defaulting country's authorities.

Summing up, the key risk associated with the dual currency system as suggested in this paper is that such a system could fail to efficiently deliver a real depreciation of the new currency combined with an improvement in competitiveness. The way in which the denomination operation is designed and carried out should support the desirable course of depreciation; denomination policy should also facilitate low inflation and minimize the risks involved. Since drachmas could only be bought in exchange for the euros (euro-denominated assets) and an abundant capital inflow would be highly improbable, there would be no excessive issuing of the new currency and prices should be relatively stable – regardless of the fact that drachmas would be sold for euros at a devalued price.

However, the national central bank, which in principle is able to supply its own money, in addition to its role as a component of the Eurosystem, could use these powers to meet other targets. In particular, it could decide to inject liquidity in drachmas into financial institutions through refinancing operations where acceptable collateral could include underperforming assets, also denominated in the drachma[4]. Such an expansive policy could be aimed

[4] Any active monetary policy involving the national currency would add to doubts about whether or not the country should remain in the eurozone.

at strengthening financial institutions and could also have an aspect of quantitative easing. Moreover, the central bank could go even further in the dual currency system and recapitalize commercial banks, providing newly created drachmas in exchange for property rights. This, of course, would be far from a conservative approach to the role of the central bank and far beyond its role as a lender of last resort. However, if, in the face of a possible systemic collapse, the recapitalization operation could not be undertaken by the indebted government, such a conservative approach could lose its appeal. Of course, the usual reservations, including the problem of moral hazard, would remain valid.

Regardless of the possible scope for traditional and non-conservative expansionary monetary policy with respect to supplying drachmas, I am convinced that these options should be abandoned. The basic aim of the dual currency system should be to bring about a real depreciation, and this means that any additional targets and the monetary expansion related to them – a potential inflation booster – should be given up. Monetary policy should only be pursued within the Eurosystem, and drachmas should only be circulated in exchange for euros or euro-denominated assets.

The dual currency system, as described above, could in principle be used permanently, but that would make little sense. It enables countries to, first, exit the eurozone in an orderly manner and, second, withdraw the entire issue of the national currency, redenominate all prices back to the euro and remain a member of the monetary union with a single and common currency system. In the first situation, the change could be swift. The central bank should simply start using drachmas in its monetary policy instead of its activities as a member of the Eurosystem. Any redenomination would not be needed, no secrecy necessary, the national currency, including cash, would have already been introduced into circulation. In the second case, the country could also relatively easily become a "normal" member of the eurozone. The central bank would only have to declare that the drachma would be converted into the euro at a given exchange rate, equal to the market rate on the day of conversion. In this way all prices denominated in the drachma would be redenominated into the euro. The central bank would continue to carry out its activities as a member of the Eurosystem and would stop circulating the national currency via purchases of the euro and euro-denominated assets. It should also absorb existing drachmas; this should be easy as the drachma issue was a result of earlier purchases of the euro (euro-denominated assets). Drachma notes and coins could circulate for a period of time substituting for the euro.

I must emphasize that the second scenario is far from the QIR approach I mentioned earlier. Firstly, the country does not exit the monetary union at any moment, although, secondly, it really reintroduces its national, parallel currency. Thirdly, the dual currency system may last long enough for the necessary adjustment to fully take place.

At the time of introducing the dual currency system, there is no need to determine just how long a country would keep its dual-currency system and whether it would eventually exit the eurozone or, just the reverse, decide to give up its national currency. This could be subject to further analysis based on past developments and future prospects as well as on the reassessment of the role of the single currency.

Finally, with respect to the remarks in the introduction on an alternative to the present policy of forced "deepening" of monetary integration, this paper shows that it is possible to arrange a process of an orderly reintroduction of domestic currencies followed by a potential exit from the monetary union. Whether or not to arrange such a process is a matter of choice and ingenuity.

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SYSTEM DWUWALUTOWY JAKO ROZWIĄZANIE KRYZYSU STREFY EURO

Streszczenie

Celem artykułu jest wskazanie znaczenia, jakie wprowadzenie dwuwalutowego systemu może mieć dla rozwiązania obecnych gospodarczych problemów kilku krajów strefy euro, przede wszystkim Grecji. Proponowany dwuwalutowy system oznacza utrzymanie uczestnictwa w strefie euro z jednoczesnym przywróceniem waluty krajowej, „nowej drachmy".

Uzasadnienie omawianej koncepcji wynika z analizy źródeł i charakteru obecnego kryzysu, który cechuje znaczna utrata międzynarodowej konkurencyjności i nierównowaga płatnicza krajów szczególnie dotkliwie dotkniętych przez kryzys. Analiza ta prowadzi do wniosku, że dewaluacja (raczej niż „wewnętrzna dewaluacja") może być kluczowym elementem uzdrowienia sytuacji.

Dewaluacja wymaga jednak przywrócenia krajowej waluty i – w ramach propozycji znanych z literatury – denominacji w nowej walucie istniejących zobowiązań i należności. To niesie poważne problemy natury prawnej, politycznej i ekonomicznej. Ukazana skala tych problemów prowadzi do wniosku, że opuszczenie strefy euro z chwilą wprowadzenie własnej waluty miałoby katastrofalne skutki. Wprowadzenie systemu dwuwalutowego pozwala wykluczyć lub zminimalizować ujemne konsekwencje przywrócenia własnej waluty. Artykuł przedstawia schemat możliwych działań zmierzających do skutecznego wprowadzenia systemu dwuwalutowego mającego na celu odzyskanie międzynarodowej konkurencyjności.

Słowa kluczowe: strefa euro, integracja walutowa, system dwuwalutowy

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